

**THE ECONOMIC AND BUDGET OUTLOOK:
AN UPDATE**

The Congress of the United States
Congressional Budget Office



NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

This volume is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations.

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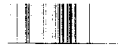
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SUMMARY

Despite the current subdued state of the economy, the Congressional Budget Office (CBO), like most forecasters, projects brisker economic growth by the end of 1986. In the year ahead, employment is forecast to rise steadily and the unemployment rate to decline. Inflation is projected to rise as the effects of the oil price decline gradually dissipate and the effects of rising import prices begin to be felt throughout the domestic price structure. Interest rates are expected to rise modestly, and net exports to improve.

In the meantime, however, the weakness of the economy, reduction in inflation, and more rapid than expected spending for several federal programs have caused a worsening of the short-run budget outlook. CBO estimates that the federal deficit for this fiscal year will reach a record level of \$224 billion, up from \$212 billion in 1985. While the deficit is projected to decline in 1987, it will still substantially exceed the target of \$144 billion established by the Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act). Under CBO's short-run forecast, the base-line deficit projection for 1987 is \$184 billion. Under the same economic assumptions but the policy assumptions specified in the Balanced Budget Act, CBO estimates a base deficit of \$173 billion. Even under the policies of the Congressional Budget Resolution, the 1987 deficit would still be \$161 billion, as shown in Summary Figure 1.

At the time this report goes to press, the near-term economic outlook is particularly uncertain. Indicators of domestic output growth reflect continuing weakness; prospects for a significant increase in capital spending remain mediocre; real consumer spending is unlikely to continue growing at the extremely rapid pace of the second quarter; and the timing and magnitude of any turnaround in net exports are still quite uncertain. Moreover, the projected large cuts in federal spending and the proposed tax reform add another layer of uncertainty to the near-term outlook.

The economy slowed in the second quarter of the year to a meager 1.1 percent growth rate after a relatively strong first quarter when gross national product (GNP) grew at a 3.8 percent rate. Some components of GNP have been quite volatile, making it difficult to ascertain whether the slowdown is likely to be transitory or prolonged.

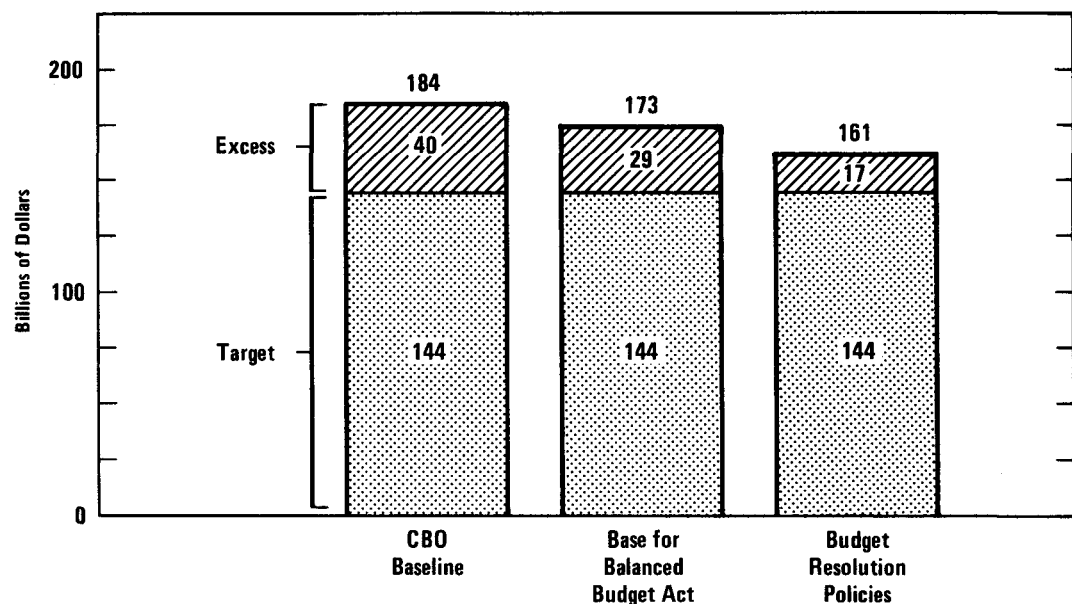
- o A surge in oil imports in the second quarter, attributable to the need to replenish low inventories, reduced net exports by about \$16 billion (1982 dollars).
- o Auto production was cut back sharply to curtail excessive inventories, subtracting 0.7 percentage point from the GNP growth rate in the second quarter.

Although oil imports are likely to continue at high levels, the oil inventory adjustment seems to be largely completed, and auto production schedules for the third quarter call for substantial increases from the levels of the previous quarter. The result could be a snapback leading to a one-time surge in economic growth.

More fundamental reasons for projecting a pickup in the quarters immediately ahead are to be found in economic developments since the beginning of the year. They include a decline in interest rates, lower inflation, the drop in petroleum prices, and further depreciation of the dollar.

Summary Figure 1.

1987 Deficit Projections Under Different Policy Assumptions^a



SOURCE: Congressional Budget Office.

^aIncludes Social Security, which is off-budget.

RECENT ECONOMIC DEVELOPMENTS

In the first half of 1986, the economy grew at a rate significantly lower than most forecasters, including CBO, had projected last winter. Real economic growth eased down to 2½ percent from the 3.1 percent recorded in the preceding six months. Inflation was also much lower than expected: as measured by the GNP deflator, inflation fell to about 2.3 percent (at an annual rate), while at the consumer level it was about zero.

The main reason for the substantial reduction in the rate of inflation was a precipitous drop in crude oil prices of some 60 percent since the end of last year--a much sharper decline than most analysts had anticipated. Although lower oil prices will clearly benefit the economy in the long run, the drop devastated the U.S. petroleum industry, so that its immediate effect on overall economic growth--and on employment--has to be adverse.

The decline in petroleum prices was not the only development in the first half of the year that bodes well for future economic growth. The dollar continued to decline against the currencies of other major industrial nations, and interest rates eased further as prospects for lower future deficits improved and the Federal Reserve continued to follow an accommodating monetary policy. These factors, together with the anticipation of continuing low inflation and of rising corporate profits, propelled the stock market to record highs by midyear and thus added hundreds of billions of dollars to household wealth.

Such favorable financial developments had led most forecasters to project a resumption of more rapid economic growth by mid-1986. But as of midyear the economy generally remained weak, and there are as yet very few signs of any pickup getting under way. The reasons for this apparent lack of response of aggregate output to improved financial conditions are not well understood and are subject to divergent interpretations by analysts. The most likely answer, even though not accepted by all, is that the economic environment has changed in such a way as to make the time lags between a price stimulus and an output response in some sectors longer than had been expected.

The weakness in 1986 has been concentrated in the manufacturing sector. Industrial production declined in the first half of 1986--at a 1.2 percent annual rate--in sharp contrast to its already sluggish growth rate of 2.2 percent in 1985. The rate of capacity utilization fell. Manufacturing employment also fell, but this was offset by strong employment growth in the

service sector. Total payroll employment rose somewhat, but a rapid rise in the labor force pushed the unemployment rate, perhaps only temporarily, from 7.0 percent at the beginning of the year to 7.2 percent in the second quarter. The decline in industrial production resulted in part from the collapse of oil drilling. But foreign import penetration and export competition also continued to depress manufacturing output.

The rate of inflation in the first half of the year was exceptionally low (see Summary Table 1). The effect of sharply falling petroleum prices on the general price level was rapid and strong, while the falling dollar has so

SUMMARY TABLE 1. RECENT ECONOMIC INDICATORS

	1984	1985	1985		1986	
			III	IV	I	II
Real GNP (percent change)	6.4	2.7	4.1	2.1	3.8	1.1
Real final sales to domestic purchasers	6.3	4.8	6.6	4.7	-1.8	5.5
Personal consumption expenditures	4.7	3.5	5.3	1.7	3.6	5.9
Business fixed investment	-16.9	9.3	0.1	12.5	-15.1	-2.6
Residential investment	14.3	3.9	11.7	3.4	11.0	15.4
Government purchases	4.0	6.8	13.9	10.0	-12.3	7.0
Inventory change (billions of 1982 dollars)	59.2	9.0	0.7	-5.2	39.9	19.6
Net exports (billions of 1982 dollars)	-83.6	-108.2	-113.8	-132.0	-125.9	-146.3
Industrial Production (percent change)	11.5	2.2	1.9	1.9	0.5	-3.0
Civilian Unemployment Rate	-7.5	7.2	7.2	7.0	7.1	7.2
Consumer Price Index, Urban Consumers (percent change)	-4.3	3.5	2.6	4.3	1.5	-1.7
Three-Month Treasury Bill Rate	9.5	7.5	7.1	7.2	6.9	6.1
Corporate Bond Rate	12.7	11.4	10.3	9.8	8.6	7.6

SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor; Federal Reserve Board.

far had relatively limited upward impact on import prices and therefore on the general price level. Food price increases remained moderate. On the other hand, prices of services continued to rise at about a 5 percent rate, and prices of goods that are relatively immune to foreign competition also continued to move up. As a result, if food and energy are excluded from the price measure, the rate of consumer price inflation has remained fixed at around 4 percent.

Economic sluggishness, together with an ample provision of liquidity by the Federal Reserve, contributed to a further easing of interest rates. They fell across the entire spectrum of maturities from short-term to long-term, reaching their lowest levels of this decade.

The lack of improvement in the U.S. foreign trade position, and a slight pickup of economic growth abroad in the second quarter, have been the main causes of the continued depreciation of the dollar. The dollar depreciated mainly against the currencies of Japan and Western Europe, while against the currencies of other U.S. major trading partners its value remained essentially unchanged.

The increase in aggregate demand in the first half of 1986 was concentrated in consumer spending and residential housing. Business inventories also rose. Despite lower interest rates, however, business fixed investment actually declined. Government purchases of goods and services also fell. Finally, net exports failed to rise from their record low level of the last half of 1985.

THE CBO ECONOMIC PROJECTION

CBO's economic projection used for making budget estimates consists of two parts: a short-run forecast of economic conditions through 1987 that is contingent on specific fiscal and monetary policy assumptions; and a medium-term projection through 1991 that is based on historical trends in economic growth.

The Forecast for 1986-1987

The short-run forecast shown in Summary Table 2 is contingent on the following assumptions:

- o Federal tax and spending policies are assumed to satisfy the deficit reduction requirement of the Balanced Budget Act;

- o The Federal Reserve is assumed to be following a policy that would allow M2 to grow at approximately the midpoint of its announced target range, provided that M2 velocity growth follows past trends;
- o The world price of oil is assumed to remain close to \$12 per barrel through the end of 1987; and
- o The exchange rate (as measured by the Federal Reserve Board index) is assumed to continue to decline, though at a much lower rate than in the past year, reaching by the end of 1987 a level about 18 percent below its level at the end of 1985.

Given these assumptions, CBO forecasts that real GNP will grow 2.9 percent over the four quarters of 1986 and at a somewhat more rapid rate, 3.5 percent, over the four quarters of next year. The unemployment rate will average 7.0 percent in 1986 and fall to 6.7 percent next year. Inflation, as measured by the Consumer Price Index, is projected to be very low--below 1½ percent in 1986--but to rise to around 4 percent in 1987, largely because of higher import prices induced by a depreciating dollar. The GNP

SUMMARY TABLE 2. THE CBO FORECAST FOR 1986
AND 1987 (In percents)

Economic Variable	Actual		Forecast	
	1984	1985	1986	1987
Fourth Quarter to Fourth Quarter				
Nominal GNP	8.5	6.3	5.3	7.5
Real GNP	4.6	2.9	2.9	3.5
GNP Implicit Price Deflator	3.6	3.3	2.4	3.9
CPI-W	3.3	3.2	1.2	4.0
Calendar-Year Averages				
Civilian Unemployment Rate	7.5	7.2	7.0	6.7
Three-Month T-Bill Rate	9.5	7.5	6.2	6.4
Ten-Year Government Bond Rate	12.4	10.6	7.7	7.9

deflator--a measure of inflation that excludes imported goods--will show a smaller increase in inflation, from about 2.4 percent in 1986 to 3.9 percent in 1987. Interest rates, having fallen substantially in the first half of 1986, are expected to rise moderately throughout the forecasting period in response to more vigorous economic activity.

Uncertainties in the Forecast

Every economic forecast is subject to a number of uncertainties. Right now, forecasting is particularly fraught with risks. Some fundamental uncertainties are:

- o The effects on the economy of the restrictive shift in fiscal policy mandated by the Balanced Budget Act;
- o The effects of the tax reform legislation now under consideration, which, if enacted, would change dramatically the incentives for such economic activities as saving, work, business investment, and homeownership.

The short-run impacts of such large changes in fiscal policy and the tax structure are a subject of controversy among economists. CBO's forecast assumes that the short-run contractionary impact of changing fiscal policy will be quickly offset by an improved trade balance and by lower interest rates than would otherwise prevail. If these offsetting forces occur more slowly than expected, an increase in economic growth may be delayed.

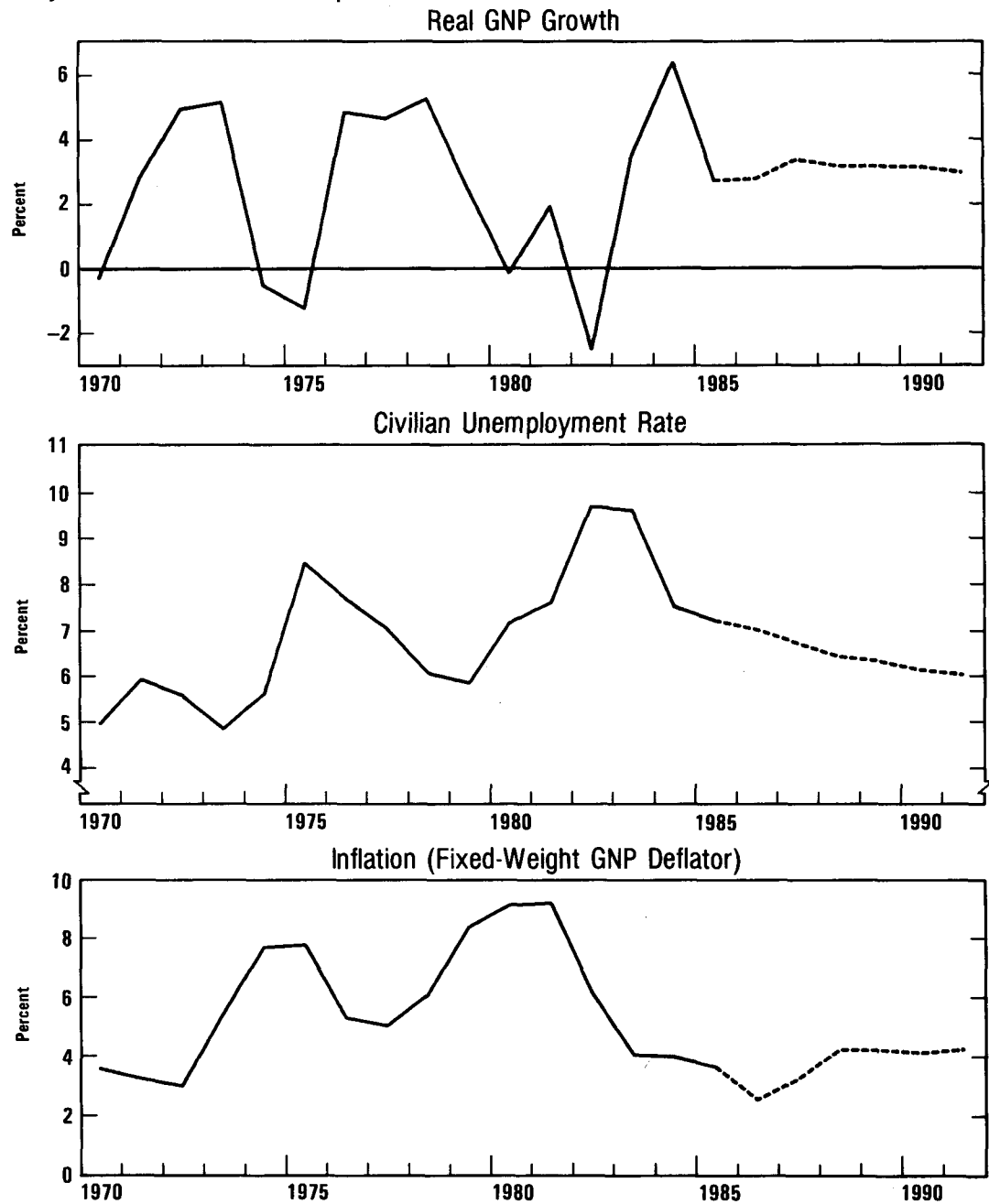
CBO's forecast is also based on the existing tax law. It is likely, however, that some private plans already reflect broad outlines of the main provisions of any new tax bill, and CBO's forecast takes into account indications of these private plans, such as information from various surveys of investment intentions, as well as more indirect indicators such as the behavior of the capital and commodity markets.

Beyond these uncertainties, and the continuing mystery of the future course of oil prices, the volatility in commodity, money, and foreign exchange markets makes this a particularly difficult time to try to forecast.

Economic Projections for 1988-1991

CBO's medium-term projections for the years 1988 through 1991, depicted in Summary Figure 2, are constructed by using certain rules of thumb based on historical experience. Real gross domestic product (GDP) is assumed to

Summary Figure 2.
Major Economic Assumptions



SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor; Federal Reserve Board.

grow at an average rate of 3.2 percent in the 1988-1991 period--the same as its average in the period 1948 to 1985. This path for real GDP, in conjunction with an estimated relationship between real GNP growth and the unemployment rate, brings the latter to 6 percent at the beginning of 1991. GNP is expected to grow slightly more slowly than GDP. This slower growth is because net earnings from overseas assets, which account for almost all the difference between GNP and GDP, will decline. The inflation rate is assumed to remain constant at 4.1 percent. Interest rates are assumed to decline by 1991 to levels that approximate historical averages for both the real short rate and the spread between short and long rates (see Summary Figure 2).

THE BUDGET OUTLOOK

Under CBO's economic assumptions and current budgetary policies, the federal government baseline budget deficit is projected to fall from \$224 billion in the current fiscal year to \$184 billion in 1987, \$150 billion in 1988, \$127 billion in 1989, and \$69 billion by 1991. Under the same economic assumptions but incorporating the policies of the Congressional budget resolution, the deficit would be \$161 billion in 1987, \$118 billion in 1988, and \$84 billion in 1989. The baseline projections substantially exceed the targets established in the Balanced Budget Act, as shown in Summary Figure 3. The budget resolution would come much closer to the targets in 1987 and 1989 and be within the \$10 billion tolerance range in 1988.

The Supreme Court decided on July 7 that the automatic deficit reduction provisions of the Balanced Budget Act are unconstitutional. Under the fallback provisions of the law, however, the across-the-board cancellation of budgetary resources remains an option for Congressional consideration. As the law now stands, on August 20 the Congressional Budget Office and the Office of Management and Budget (OMB) will report to the Congress on an estimate of the deficit for fiscal year 1987. If the average of the CBO and OMB deficit estimates exceeds \$154 billion, the Congress will be required to vote on a joint resolution that would reduce the deficit to \$144 billion by means of across-the-board spending cuts. The Congress may also reach the target through an alternative package of deficit reduction measures.

Under the budgetary assumptions specified in the Balanced Budget Act (which differ from those of the CBO baseline), CBO currently estimates a 1987 base deficit of \$173 billion. A deficit of this size would require across-the-board reductions of 8.2 percent in defense programs and 11.5 percent in